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# Market Makers' Methods of Stock Manipulation: How Trading Manipulations Can Adversely Affect a Firm's Equities and What Finance Managers Can Do About It

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# Market Makers' Methods of **Stock** **Manipulation**

BY A.J. CATALDO, PH.D., CMA, CPA, AND LARRY N.  
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## HOW TRADING MANIPULATIONS CAN ADVERSELY AFFECT A FIRM'S EQUITIES AND WHAT FINANCE MANAGERS CAN DO ABOUT IT.

If you are involved in the decision to finance assets with debt or equity and your company's shares are publicly traded or may be, you should watch for and guard against exposure to broker-dealer or market maker manipulation (MMM). In this article, we offer you a primer on MMM, "naked shorting," and Internet-based sources of additional information.<sup>1</sup> By increasing your awareness of market maker manipulation, you may be able to (1) better recognize and defeat the adverse effects of MMM on your firm's equity securities, (2) dramatically reduce the risks associated with your firm's failure to maintain market-based debt covenant ratios with lenders, and (3) avoid the need to recapitalize with additional equity issues at a manipulated or artificially low price per share.

### THE MARKET MAKER

A market maker, who handles small-sized and micro-cap stocks; an exchange floor specialist, who is involved with mid-sized or large-capitalized stocks; or a broker-dealer, who handles all stocks, performs two separate and, apparently, incompatible functions.

First, all maintain an inventory of the stocks their

firms have underwritten, continue to trade, or make a market in. They buy and sell these inventories for profit. In theory, they will buy low, which reduces the decline in price per share (PPS), and sell high, which reduces the rise in PPS. Therefore, these profit-making behaviors are presumed to provide a stabilizing effect on changes in the PPS of the stocks they make a market in.

Second, they post the bid and ask prices at which others are willing to buy or sell and match incoming buy and sell orders. In return for performing these functions, market makers or specialists generate revenue for their firm through various order-flow or transaction-fee schemes.

But like the conflicts apparent in the dual role of an analyst-broker or auditor-consultant, the broker-dealer is faced with an opportunity to sell his or her firm's inventory before others in a declining market or buy for his or her firm's inventory before others in a rising market. This practice is one form of market maker manipulation. It is illegal, difficult to detect, but alleged in many instances—both correctly and, often, incorrectly—on Internet stock-chat message boards. One relatively

highly publicized example of MMM is referred to as front running.

### **FRONT RUNNING**

In front running, specialist market makers use their knowledge of private, incoming order-flow information revealed by limit orders to generate monopolistic trading profits. Though front running per se may not be particularly damaging to your firm, it illustrates the abuse of the conflicting roles of the broker-dealer as both a facilitator of an orderly market (matching incoming orders from other investors to buy and sell) and as someone with the desire to generate profits from the inventories traded for their firm's account.<sup>2</sup>

On June 4, 2002, *The Wall Street Journal* reported that Knight Trading Group, which handled more than 11% of all the buy and sell orders for Nasdaq-listed stocks in 2000, was under investigation by the Securities & Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) for alleged front running. Knight's former head of institutional trading accused Knight traders of front running. He alleged that the traders placed their own orders for stock before placing the same orders for Knight's customers, profiting in advance from customer orders they knew would push the stock of a company up or down, costing investors millions of dollars. The day the *Journal* story was published, Knight's chief executive issued a statement denying the allegations. In November 2002, Knight announced that the SEC began formally investigating the front-running charges. The investigation has not yet been concluded.

Another type of market manipulation is the naked short sale. Firms with a declining PPS are targeted for naked short selling. This practice is very damaging to the publicly traded firm and may be popular among the offshore brokerage firms where U.S. securities laws are less easily enforced or do not apply. It is similar to the counterfeiting of currencies. In a naked short sale of stock, short positions are not declared or disclosed, shares are not borrowed to cover the short sale, and the stock is never delivered to the purchaser. The result is dilutive in that it results in an artificial, unauthorized, and illegal increase in the number of shares issued and outstanding and in a manipulated decline in the PPS of the firm's

stock. The broker-dealer merely floods the market with cheap, nonexistent shares of your firm's stock. The seller of these nonexistent shares keeps the proceeds.<sup>3</sup>

For example, on August 13, 2002, GeneMax Corp. announced concerns over naked shorting and took measures to ensure that trading in their shares occurred in a "fair and appropriate manner."<sup>4</sup> Records indicated that as of August 2, 2002, shareholders of record held 400,820 shares, where only 265,654 were available, free-trading shares, leaving the Depository Trust Corporation and Canadian Depository for Securities Limited with a net deficiency of more than 168,000 shares.

On August 16, 2002, a two-year federal sting led to the indictment of 58 stock brokers and corporate executives. The unsealed indictment alleged stock manipulation of JagNotes.com, Softsquad Software Ltd., and C Me Run Corp. On January 23, 2003, Jag Media Holdings, Inc., the parent company of JagNotes.com, announced that it would allow "custody only" trading of its stock to protect stockholders against naked short selling. Under custody-only trading, a company's stock is issued only in the name of beneficial owners in physical certificate form.

Even the once large-capitalization, business-to-business firm PurchasePro.com, in an open letter from the CEO, suggested that shareholders move their holdings to cash accounts or request delivery of their share certificates to prevent the shares from being legitimately shorted.

### **STOCK-CHAT MESSAGE BOARDS**

We recommend that publicly traded firms, particularly small-caps and micro-caps, monitor the Yahoo! Finance and Raging Bull stock-chat message boards. This additional task doesn't need to be onerous but requires some understanding or review of the history and sophistication of the person who is posting the message. For example, an unsophisticated investor attempting to purchase 5,000 shares of your firm's stock may receive what is referred to as an automatic execution or a partial fill of a larger limit-price day order for 100 or 200 shares.<sup>5</sup> Here, for example, is one message:

*OT: I can't believe that someone bought \$2 worth of stock (100 shares) and paid a minimum \$8 dollar (sic) commission.<sup>6</sup>*

## Table 1: Stock-Chat Message Board Summary Worksheet

Message Board	Message Number	Date	Time	Author or Alias	Issue or Content	Our Comments
Raging Bull	94231	4/12/2002	11:17 a.m.	Aim4theFence	Small Trade	Auto Execution. Unsophisticated.
Yahoo! Finance	19751	8/1/2002	6:23 p.m.	wall street guy	Stop Losses	Market maker takes out stops. Sophisticated.

This unsophisticated investor failed to understand that an automatic execution caused the transaction for 100 shares of a stock selling at two cents per share. This was a partial fill from a larger order but was misinterpreted as a completed trade. These transactions are often blamed on MMM but result only from a buyer's failure to place an all-or-none order.

Another message is about a large spread between the best bid and lower bids:

*Some unfortunate traders were thought (sic) a sorry lesson today using stops. Use stops on IWAV and you will be taken out.*

This sophisticated investor is referring to stop loss market orders for the stock of Interwave Communications International, suggesting that the market maker was able to sell a few shares (even to himself or herself) to reach or activate the stop loss orders, buy a large quantity of cheap shares, and allow the PPS to rise quickly, rebounding to the appropriate market value per share. These trades are very profitable for the market maker but could also have been made by sophisticated individual investors who use the Nasdaq Level II quote system (L2).<sup>7</sup> L2 provides additional information to those buying or selling a security, including the depth of bid-ask spreads, by broker-dealer.

Repeated complaints of these types of trades on the stock-chat message boards may suggest that the issuer do a preliminary investigation into the day's trading log and MMM.<sup>8</sup> One form of market maker manipulation may be a predictor of future, more damaging cases of MMM. In any case, high frequencies of trading complaints may lead new or potential investors to avoid investments in your firm's stock.

We recommend you develop a checklist summary

that you periodically review. Table 1 provides a simple example of the format you may want to use to monitor people on stock-chat message boards. You can modify this format as your experiences require.

### DETECTION METHODOLOGY

The simplest way to detect MMM in your company's stock is to have one or more of your administrative personnel monitor the stock-chat message boards for comments or complaints about trading of it. Only unusual commentary or atypical stock price or volume activity would be cause to investigate further.

We recommend monitoring trading in your company's stock on L2 when posting activity increases, stock price or volume behavior is atypical, or a large number of complaints are detected on the stock-chat message boards. The level of sophistication can often be determined by reviewing the aliases' posting history, a feature available on both Raging Bull and Yahoo! Finance stock-chat message boards.

Finally, you should not respond directly to stock-chat message-board complaints because, as a company insider, you may violate the SEC's Regulation FD (Fair Disclosure). ■

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- 1 For example, see: <http://www.nakedshortselling.com/>. An example of an NASD Regulation complaint, hearing details, and their findings of fact may be found at [http://www.nasdr.com/pdf-text/nac0599\\_02.txt](http://www.nasdr.com/pdf-text/nac0599_02.txt).
- 2 Individual investors discuss these behaviors on stock-chat message boards. Even when the period of front running is brief, it rarely goes unnoticed. Individual investors post messages about their own trades and the failures of market makers to honor their trades in the legally required sequence. In fact, one of the authors has had personal experiences with this behavior, which was later corrected after complaints were filed with myTrack, an online broker. In that case, market makers refused to honor the trade, which was in the money at the time of the complaint. But myTrack resolved the matter prior to the close of the trading day.
- 3 This and other trading manipulations are governed by restrictions enforced by the SEC, the New York Stock Exchange, and the NASD. For example, short sales cannot be executed in a declining market, and manipulation is specifically prohibited. See SEC rules 10a-1 (the uptick rule) and 10a-2 (the availability/delivery rule), NASD rule 3350 (the best bid rule), and Rule 105 of Regulation M.
- 4 For GeneMax's announcement and its discussion about naked shorting of its shares and a tabular accounting of them, see [http://www.genemax.com/pdf/genemax\\_pr\\_08-13-02.PDF](http://www.genemax.com/pdf/genemax_pr_08-13-02.PDF).
- 5 An automatic execution is a trade for 100 or 200 shares—a partial fill of a larger order—regardless of the size of the order above 200 shares. For example, a 5,000-share buy order may have had 100 shares filled immediately. The remaining 4,900 shares of the order may or may not have ever been filled or the original order completed. The broker will advise customers that the automatic execution is designed to increase or broaden participation in a firm's stock. An alternative or less positive view is that it maximizes broker commissions and order flow, particularly in cases of low-priced or penny stocks.
- 6 OT is an abbreviation for "off-topic," used, for example, to suggest or provide tips or insights on other stocks.
- 7 Market makers are often blamed for these trades because they are presumed to have access to the execution price of stop loss orders. Some explanatory materials about L2 are located at [http://daytrading.about.com/library/weekly/aa061900a.htm?PM=ss13\\_daytrading](http://daytrading.about.com/library/weekly/aa061900a.htm?PM=ss13_daytrading).
- 8 For example, myTrack, an online broker, provides a detailed transaction log for the prior and current trading day. For an additional monthly fee, the market maker, through which the trades were executed on L2, can be identified in real time. Other online brokers may also provide this free service, and the issuer's investor relations department may make inquiries with their exchange or transfer agent.